THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 294 **October 1997**

Profit Squeeze

"My chief objection to the prevailing "macro-theory" is that it pays attention only to the effects of changes in the quantity of money on the general price level and not to the effects on the structure of relative prices. In consequence, it tends to disregard what seems to me the most harmful effects of inflation: the misdirection of resources it causes and the unemployment which ultimately results from it."

— New Studies, F.A. Hayek, 1978
Routledge & Kegan Paul, London

In previous letters we have taken a close look at profits and productivity growth and have made sobering discoveries about both. We have shown that plunging interest costs — rather than accelerating productivity growth — have been the main reason for the rise in profits in the 1990s. Without this sharp decline in interest costs, it would have been a profitless boom. Consequently, we have warned repeatedly of an impending profit slowdown.

Today we find the list of U.S. blue-chip companies issuing earnings warnings is lengthening almost daily. But while single stocks have suffered heavy losses, the market as a whole has held up very well: Wall Street continues to discard these troubles as "company-specific", rather than as indications of a serious change in trend.

In this month's letter we illustrate that the U.S. economy is in fact heading for a profit squeeze that has three main reasons: lack of pricing power, lack of productivity growth, and rising wage pressure.

LURKING DANGERS

With the benign September 16th report on August consumer prices, U.S. financial markets excitedly discounted the likelihood that the Fed would continue to stand pat, despite tight labor markets and strong growth. The 30-year bond dropped 17 basis points to yield 6.4 percent, its largest one day rally in over a year. The Dow gained 177 points, its fourth largest point gain in history.

The report actually came basically in line with expectations, but with the economic and financial tumult in Southeast Asia, disturbingly weak economic data out of Japan and pronouncements from Mr. Greenspan and other Fed members as to the priority of goods and service inflation as the target of monetary policy, this particular release certainly solidified growing confidence that fears of any Fed restraint are unjustified.

Small caps have become the star of the party. Since its lows established in April, the Russell has gained 28 percent, versus 17 percent for the S&P 500. Year-to-date, the Russell 2000 has narrowed its underperformance, gaining 23 percent compared to 28 percent for the S&P 500, 23 percent for the Dow, and 39 percent for the NASDAQ Composite.

The bull story in the markets centers on a rotation from the "blue-chip" multinational consumer stocks to small caps and "value" stocks. This shift is supposedly due to waning pricing power and a declining confidence in the profit outlook for the large caps. In fact, the list of blue chips having issued earnings warnings lengthens

almost daily: Coke, Gillette, McDonald's, Owens-Corning Rubbermaid, MCI, Eastman Kodak, Union Carbide, Nike, Avon, Proctor & Gamble, Boeing, Aetna, Delta, etc. Simple logic, though, raises the question: if the dominant companies lack pricing power, why not the rest?

According to available statistics, actual profit figures beg this same question. Smith Barney just published an analysis of growth in earnings per share year-over-year for the S&P 500 to the second quarter of 1997. It found that such profits had in the case of the top 25 increased 15 percent. The remaining 475 saw only a tepid 6.86 percent rise. Moreover, the study warned of an ongoing downtrend.

Clearly, the prominence and the diversity of the companies issuing warnings is testament to a wide scope of profit trouble. But typical of Wall Street's superb cunning to turn anything bad into something bullish, these announced profit concerns have promptly been molded into a bull story for small caps: they are represented as stocks that have "underperformed for 16 months" and which therefore offer "compelling relative value" for investors. Never is it mentioned that the Russell 2000 trades at a price-to-earnings ratio of 35 and a dividend yield of 1 percent.

Interestingly and importantly, the large technology stocks are left in a strikingly ambiguous status by this market rotation. Clearly, these companies are heavily exposed to the Asian economic, financial and currency turmoil. From sharply reduced growth expectations in Asia to heightened competitive pressures, prospects have become acutely less clear for the industry. As "new era" cult stocks and major importers of now less-expensive Asian technology components, Compaq and Dell stocks rise almost daily as they fixate investors and media alike. At the same time, the list of warnings and disappointments becomes too long to be ignored: Gateway 2000, Motorola, Intel, Microsoft, Hewlett Packard, Oracle, Cisco, Altera, Hutchinson, Seagate, Advanced Micro Devices, Ascend Communications, Micron Technology, to mention just the household names.

While Wall Street continues to implore "company-specific" problems to explain away industry-wide concerns, it is getting clearer by the day that over-optimistic profit expectations and widespread extreme valuations are at odds with the keenly competitive environment. Remarkably, with the strong market rally in the past months, the leading technology stocks are noteworthy for their lack of any advance. See Morgan Stanley High Tech (MSH), the semiconductor (SOX), and the high tech-heavy NASDAQ 100 (NDX) indexes. Leaders Intel, Microsoft, IBM and Cisco are trading poorly and well below their highs.

Adding to the concern for technology stocks and other multinationals is the growing recognition of the depth of Asian financial difficulties. What began as a Thai currency problem has spread like wildfire to encompass the region's financial markets. Collapsing currencies and stock markets are the most spectacular hallmarks of the financial disaster, certainly breeding incalculable economic troubles.

> ***"With profit prospects waning, the undaunted bulls show increasing gumption in creating apparently appealing but absolutely nonsensical "theories" explaining away poor fundamentals and justifying the bull market."***

The Thai baht is 32 percent below its June level; the Indonesian rupiah, 19 percent; the Malaysian ringgit, 18 percent; the Philippine peso, 24 percent; with smaller losses for the Korean won, Singaporean dollar and Taiwanese dollar. The biggest losers, however, are the equity markets. The declines from highs are 66 percent in Thailand, 47 percent in South Korea, 40 percent in the Philippines, 38 percent in Malaysia, 29 percent in Indonesia, 25 percent in Singapore 25 percent, 31 percent in Australia 31 percent, and 15 percent in Hong Kong. Not to forget Japan, where the NIKKEI remains 54 percent below its 1989 high. And these numbers are in local terms. The losses for dollar-based investors are all the greater.

Clearly, investors are grappling with both the short-term and long-term prospects for the U.S. financial markets. Daily wild market swings continue unabated, and volatility — as measured by option premiums — is

at an extreme. Nonetheless, as the torrent of mutual fund inflows seem to recover, investors and fund managers tend strongly towards small caps. Unfortunately, these are the market's most illiquid sector. The entire market value for the Russell 2000 is little more than $1 trillion, about equal to the top six stocks in the S&P 500. While it therefore takes little money to push these small cap stocks up, especially with the high leverage of derivatives, there is no chance of exit without dramatic falls when the market turns.

As U.S. profit figures are losing their luster, low inflation rates are increasingly hailed as the key to ever-higher stock prices. In our view, this role is grotesquely exaggerated compared to the growing risk of disappointing profits. Most probably, it is in reality the loose monetary stance associated with low inflation, that these people have primarily in mind.

In actual fact, gaping holes are appearing in Wall Street's bull propaganda. Until now, the trumpeted story of exceptional and endless profits was enough to detract from the pathetic performance of the critical long-term economic fundamentals, such as savings, productivity and trade balance. With profit prospects waning, the undaunted bulls show increasing gumption in creating apparently appealing but absolutely nonsensical "theories" explaining away poor fundamentals and justifying the bull market.

"Wall Street's die-hard bulls don't capitulate to statistical evidence. Rather than questioning their own concept, they simply contradict the validity of the disastrous statistical verdict, accusing the statisticians of fallacious measuring."

With Mr. Greenspan's barrage of bullish commentary — including a recent Business Week quote, "nonfarm productivity data are nonsense" — it is now free game to dismiss any data not categorically bullish. Lawrence Kudlow, chief economist at American Scandia, noted supply-sider and high-profile chief economist, repeatedly states the falsity of the trade deficit data. Robert Hormats, vice chairman of Goldman Sachs discards the miserable savings rate as no problem owing to the superior quality of U.S. current investment. High-profile bull Michael Holland took nonsense to a new level when he recently celebrated Union Carbide's earnings warning and admission of pricing and margin deterioration by propounding that the ensuing higher "technology investment" would now lead to prosperity for Union Carbide, and, of course, for technology enterprises.

BRAVE NEW WORLD?

What matters most for future prosperity? The short answer is that, for real economic miracles, the one thing to look to is productivity growth — in other words, the rise in output per worker. How the national product is distributed between the stakeholders in the economy, then, depends on wage rates, interest rates and tax rates. As an aside: rising stock prices add *nothing* to national wealth, which is embodied in two aggregates, no more, no less: the net increase, after depreciation charges, in the stock of tangible assets plus or minus foreign net assets or net debts. But, by these two measures, U.S. real wealth creation is presently at its lowest level ever.

Among the industrial countries, the U.S. economy stands out presently with the strongest sustained employment growth. But the black spot in the bright picture is dismal productivity growth. U.S. overall productivity gains first began to slip after the mid-1960s. Until then, output per worker had risen at an annual rate of 2.7 percent. By 1973 on the eve of the first big oil price jump, it was down to 1.8 percent per annum. Ever since then, it has stayed below 1 percent. Neither the 1980s nor the 1990s have so far brought any meaningful improvement. At least that's what the national GDP and income statistics say, belying the much-ballyhooed great efficiency gains from the exploding usage of computers proclaimed by Wall Street.

But Wall Street's die-hard bulls don't capitulate to statistical evidence. Rather than questioning their own concept, they simply contradict the validity of the disastrous statistical verdict, accusing the statisticians of fallacious

measuring. For them, the mere ability of the U.S. economy to deliver simultaneously strong growth, low unemployment, rising wages, apparently strong corporate earnings, and the lowest inflation rates in decades is compelling proof of a breakthrough in productivity, implying the long-term persistence of this "golden" scenario — with the promise of a permanent nirvana for the financial markets. In short, a "New Era".

To nobody's surprise, this "new era" vision is the rage on Wall Street. More difficult to believe is the fact that it has a highly sympathetic fellow traveler in the nation's No. 1 economist, Fed chairman Alan Greenspan. A recent Business Week cover story, titled "Alan Greenspan's Brave New World", reveled about the Fed chief as "the staunch conservative who once personified industrial-era economic thinking and has turned into the *avant garde* advocate of the New Economy". One day, we think, he will deeply regret this metamorphosis of his.

Why all the fuss about such a seemingly dry academic concept? Well, it's far more. Sustained, significantly higher productivity growth is the indispensable precondition for a possible continuance of the U.S. stock market boom. It alone would permit the sustained coexistence of higher corporate earnings with low inflation. Mr. Greenspan's repeated allusions to a hidden productivity miracle certainly may have the further motive of fending off any rate hikes. He seems almost desperate to maintain his accommodative monetary looseness.

THE WEAKEST U.S. ECONOMIC RECOVERY IN DECADES

Frankly speaking, all this "new era" talk about low inflation as an index of economic health eerily reminds us of virtually equivalent talk in the 1920s, with one important difference. Then, the persistence of literally zero inflation was truly underpinned by average annual productivity gains of 6 percent, provided by the "industrial revolution". This time, the big productivity gains from the "information technology revolution" are just empty talk, pure mirage.

"The big productivity gains from the "information technology revolution" are just empty talk, pure mirage."

The first point to see is that the U.S. economy's current expansion, having started in early 1991, has in reality substantially underperformed past cyclical upturns. During the first five years of the current expansion, until early 1996, real GDP growth averaged barely 2 percent per annum. The economy's belated spurt, which is now widely hailed as heralding a "new era" of strong growth with low inflation, only started in the second quarter of 1996 with an average growth rate of 3.5 percent for the twelve months. During the recovery as a whole, real GDP has on average grown a relatively lackluster 2.8 percent annualized. For comparison: In the long 1980s recovery, it grew during the first 6 years a much stronger 4.2 percent.

PRODUCTIVITY GROWTH IN THE USA

A "New Era"? - Yes, of *falling* productivity growth

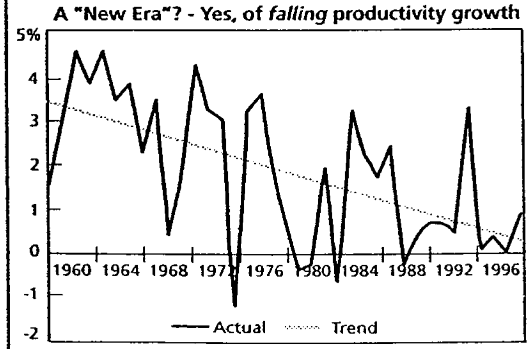


Chart shows annual change in output per hour in the business sector and the trend of the same series, estimated by fitting a linear time trend to the data.

Source: Economic Indicators, Economic Report of the President 1997, Reproduced from Lombard Street Research Monthly Economic Review, London — September 1997.

Even if we cheer the coincidence of accelerating growth and decelerating inflation as an unusual, if not sensational event, it is outright absurd to instantly extrapolate a miraculous, "new era" long-term trend from an experience of little more than one year. As to us, we can only say that the closer we look, the plainer the evidence of a "bubble" economy becomes. As already outlined in the last letter, there are greater excesses and imbalances in the U.S. economy and in the financial markets than ever before. But those who pay attention only to consumer prices will not see it.

In the "new paradigm" economy, which promises permanent, strong, inflation-free growth, the technology boom is clearly of critical "psychological" importance. All too obviously,

many are looking at the computer revolution as the magic that is sparing America the toil of having to save and to invest its way back to higher economic and productivity growth.

Still, outside Wall Street, too, the subject is under serious discussion, albeit with little or no resonance in the media. In contrast to Wall Street and Mr. Greenspan, the academics generally accept the statistical evidence of no meaningful improvement in productivity in recent years. There is even wide agreement in the explanation of this failure, albeit with some differences in emphasis. Three main explications are offered and widely accepted:

1) Even though the usage of computers has exploded so dramatically, they still represent only a very small fraction of perhaps 2-3 percent of the huge, existing capital stock, far too little to have a significant impact on aggregate productivity. There are gains, in other words, but they are insignificant relative to the overall capital stock.

2) The soaring information capital contributes little or nothing to manufacturing output. While revolutionizing office work, the computer has a limited impact on the production line, where productivity is mainly generated.

3) Computers do provide valuable customer services through improved convenience, but these values are largely not counted as an increase in output. Correctly so, in our view. Companies may even be encouraged to engage in activities that are mostly wheel-spinning, ultimately providing output of questionable value.

The truth rather is that the U.S. economy badly lacks the fundamental essentials that make for higher productivity in the long run. While information technology is the star in the scenario, raising productivity also requires substantial capital accumulation through saving and the investment of those savings into productive plant and equipment. Precisely because of poor productivity growth, the preservation of profitability depends so crucially on keeping labor costs down. Conversely, the low labor costs preserve labor-intensive, low-productivity growth.

As to the necessity of higher thrift, it seems a dirty word for the Wall Street pundits and Mr. Greenspan. They never mention it. While they proclaim an economic miracle, we see an economy in which overconsumption is increasingly draining an already shallow pool of domestic savings. Consider this: consumption in the 1990s hit its highest share ever of GDP (68.6 percent); at the same time, from 1992 to the first half of 1997, the U.S. personal savings rate has plunged from 6.2 percent of disposable personal income to 3.6 percent, and from 4.5 percent of GDP to 2.8 percent.

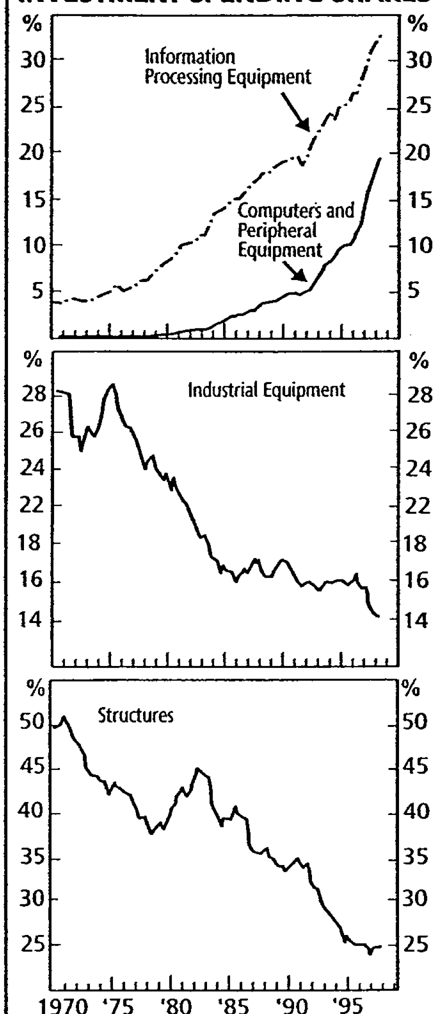
"Many are looking at the computer revolution as the magic that is sparing America the toil of having to save and to invest its way back to higher economic and productivity growth."

Mr. Greenspan has remarked, "it's difficult to avoid the conclusion that productivity is growing faster than the data indicate". By contrast, we find it difficult to avoid the conclusion that the disappointing productivity data are perfectly correct. What's worse, we suspect that the U.S. statistics are more probably *overstating* productivity and GDP growth, owing to the peculiar way computer output is measured in the official statistics.

A main reason for the explosive growth of computer output and investment, shown in the statistics, is that the Commerce Department constructed in 1986 a new, so-called hedonic price index for office, computing, and accounting machinery. The idea was to capture the rapidly rising capacity and quality of computers being produced and installed. As the "computer power" has virtually exploded, the soaring computer figures in the GDP statistics increasingly reflect spending that has never taken place.

Just to give an idea: in dollars, U.S. business spending on information technology has since 1992 increased by 53 percent, but in terms of computer power, which is the aggregate that goes into real GDP, it rose 117 percent. A similar calculation applies, of course, to the huge consumer spending on information technology. High tech, for sure, has in the last years decisively propelled U.S. economic growth, accounting for up to 33 percent of real GDP growth. But wondering how much or how little of this measured new computer power is effectively used, we ask ourselves, how great a part of the ensuing substantial additions to GDP growth reflecting computer power should better be considered as "phantom" growth?

INVESTMENT SPENDING SHARES



Note: All series are shown as percent of non-residential fixed investment

Source: BCA Publications Ltd. 1997

Now to the most bizarre part of the impact of computers on U.S. productivity and real GDP growth: it is true that computers have considerably enhanced U.S. productivity growth but in a way that radically differs from the visions of the "new era" crowd.

To understand the puzzle requires a distinction between two potentially different productivity gains from computers. The one refers to their broad *usage* across the whole economy, and the other one refers to the huge productivity gains in the very narrow sector of high tech *manufacturers*.

What the "new era" proponents have in mind are supposedly big productivity gains from widespread computer *usage* in the economy as a whole, the existence of which the statisticians, however, deny. But little recognized is the fact that an inordinate part of the economy's actual modest productivity gains do accrue from the extremely narrow sector of high tech *manufacturing*. This small sector is estimated to account for one full percentage point of the 2.7 percent average annual productivity growth of manufacturing as a whole. That is, over a third of national productivity growth in the past few years has come from high tech manufacturing, implying all the less productivity growth elsewhere.

A PROFITLESS BOOM

Now to the key question concerning the stock market: What does this absence of higher productivity growth imply? Putting it briefly: for profits, it is unambiguously bearish.

Unquestionably, the recorded sharp revival of profits gave the run-up of stock prices in the 1990s powerful support. But what was it that boosted profits? As already said, Wall Street readily explained it with hidden productivity gains, assuring more of the same for many years to come. Against this, we have just as persistently held that the profit miracle is just as phony as the productivity miracle because the true cause of their exceptional rises were big windfall gains from the slide in net interest costs.

Though it's an old theme in this letter, the following table once more substantiates the facts in a new way. The key is the fourth column showing corporate profits before tax and interest costs for every five years since 1960. It focuses on profits as reported in the national income and profit account (NIPA). While earnings reported by the companies are prone to distortions and even manipulation, these NIPA profits are part of a consistent set of economic data.

This table plainly devastates the "new era" profit miracle. Without the big interest windfall, the corporate profit performance would have been the poorest in the whole postwar period, except for 1965-70. If you further consider that the 1990s cover a prolonged cyclical upturn, it deserves to be called a disaster.

While Wall Street and Mr. Greenspan like to cite the profit performance of the 1990s as conclusive proof of hidden productivity gains, our calculations firmly suggest the opposite: adjusted for interest costs, the extremely poor profit picture which then comes to light is the compelling proof of the complete absence of any such hidden gains.

Gross profits of nonfinancial corporations actually increased overall by 82 percent between 1990 and 1996, or 13.6 percent annually. Though high, even that is by no means outstanding for a long recovery phase. But ex the windfall gains from lower interest costs, the rise in profits (before taxes and interest costs) shrinks to miserable 28.7 percent overall, or less than 5 percent annually. By the way, this compares with a simultaneous rise in stock prices, as measured by the S&P 500, of almost 200 percent. Full insanity started at the beginning of 1994. During the two-and-a-half years since then, corporate profits grew by altogether 25 percent, compared with a more than 100 percent rise in the S&P 500. For the twelve months to the second quarter of 1997, overall NIPA profit growth was down to 5.1 percent.

CHANGES IN PROFITS BEFORE TAX AND INTEREST COSTS (IN $BILLIONS)

	Profits Before Tax	Net Interest	Tax and Interest	Increase in %
1960	51.1	11.2	62.3	
1965	78.8	21.1	99.9	60%
1970	78.4	40.0	118.4	18.5%
1975	140.4	80.0	220.4	86%
1980	214.4	191.9	433.3	96.9%
1985	229.9	337.2	567.1	30.9%
1990	371.7	467.6	839.0	48%
1995	622.6	403.6	1,026.2	22.3%
1996	676.6	403.3	1,079.9	28.7%*

**Increase also relates to 1990*

The last line (1996) relates to 1990. That is, in six years profits from production before net interest cost have risen overall 24.3% or 4% per year. Apart from 1965-70, that is by far the lowest rise in the whole postwar period. This very low profit growth, associated with near stagnant real wages, is of course perfectly in line with very low productivity growth.

Source: Department of Commerce, Survey of Current Business, May 1997

It is another open secret that corporate profits are moreover widely adorned by accounting tricks and financial "engineering". (Remember the role of Japan's own particular brand of financial engineering, *zaitech,* in its bubble?) That's really what the "buy-back" mania is all about. Apart from tending to buoy stock prices directly, it raises earnings per share, on which the market focuses, simply by reducing the number of outstanding stocks. After amounting to $116 billion last year, this year's purchases have already surpassed that figure.

Stock options have also become ubiquitous. The claim is that they serve as an incentive, but they also have the convenient side-effect of enhancing profits by shifting substantial wage expenditures out of the profit and loss account and into the stock market. Sporadic news of big losses in derivative trading gives glimpses of widespread activity in these markets. Trading by companies in options of their own stock is big business on Wall Street. Intel pocketed in one year $423 million from such derivative trading.

Another practice to lift profits, common among mature corporations, has been to sneak future costs into popular restructuring write-offs. In a market that is so greedy of earnings growth, all this is happily accepted. Yet, there seems a growing public suspicion of many of these methods used to inflate earnings, including the spreading use of stock options.

In our view, the sudden growing number of announcements of profit warnings by blue-chip companies indicates that they are increasingly running out of options to enhance their profits through speculation and accounting tricks.

LOW INFLATION BY DEFAULT

Next to the imaginary productivity growth, it is the fall in the inflation rate, despite strong economic growth and low unemployment, that inspires Wall Street's talk of a "new paradigm". For a long time already, we hold and have expressed the view that price inflation for goods and services has globally ceased to be a grievous threat. In the longer run, by the way, this applies also to the United States. Realizing that this is becoming a widespread view, we hasten to add that our reasoning in this respect is worlds apart from that of the complacent consensus view.

For the time being, the U.S. economy is certainly overheating in two key areas: consumer spending and high tech, not to speak of the overheated financial markets. the hallmark of the first is the slide in the savings rate, obviously fueled by the stock market-related wealth euphoria. Given the very low unemployment rate, a prudent central banker would not watch this without interfering. The other conspicuously overheating area is high tech. Cheap hardware is spurring massive spending on software and systems, the internet and corporate systems — boosting also employment growth.

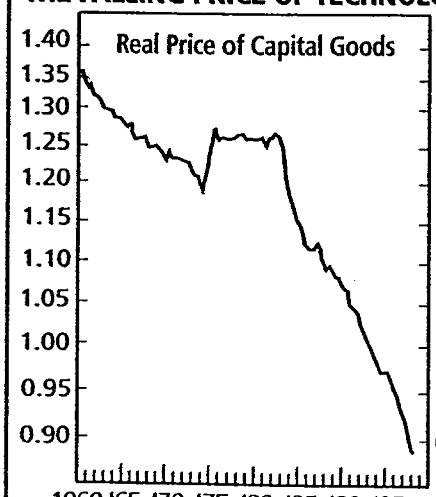
Back to the question of inflation. Looking at the world as a whole, at least three major reasons for this low inflation are easy to see: a general lack of economic growth, a lack of wage pressure, and widespread industrial overcapacity. Under these circumstances, the resulting global decline in inflation rates is not a miracle, but a very natural outcome.

But what is it that has brought all this about? While Wall Street, always eager for rosy explanations, attributes this benign inflation trend happily to more intelligent monetary and fiscal policies, we see behind this development primarily serious economic and financial maladjustments that are the legacy of the bad monetary and fiscal policies in the past. Their common denominator is the global ravaging of capital formation, always the mainspring of long-term economic growth.

In the United States, the main evil was and still is excessive private consumption; in Japan, both the economy and the financial system were heavily maladjusted mainly through huge malinvestments and the resulting mountain of bad debts; in Continental Europe, the preferred device to ruin economic growth has been fiscal and wage excesses. If price inflation is under control, it really is so by default of past and present policies.

By suppressing the former strong investment cycle and economic growth, these malignant policies have in lockstep suppressed price inflation of goods and services. That's the one point. The other is that these growth-impairing maladjustments have made the economies relatively unresponsive to monetary ease and low interest rates. One of the upshots is that the expansionary and inflationary effects of loose money converge in the booming global financial markets.

THE FALLING PRICE OF TECHNOLOGY



Source: BCA Publications Ltd. 1997

The resulting economic development — best described as "capital consumption" — shows in the corporate sphere four pronounced features: *first*, corporate capital expenditures are in general limited to available current cash flow; *second*, corporations borrow not to invest in new plant but to fund financial transactions such as mergers, acquisitions and stock repurchases; *third*, corporate equipment spending has been drastically shifted toward short-lived instruments, in particular computers; *fourth*, traditional cyclical industries have been largely replaced by high tech, whose products — owing to huge productivity gains — have falling prices.

In this way, low inflation has become common currency in the world. It's stronger growth and low unemployment that distinguishes the U.S. case. Still, pay pressures in the U.S. have

remained subdued. And we must not forget the tremendous inflation-suppressing effect exerted by the huge U.S. trade deficit. Even more important appears the fact that one fourth to one third of U.S. economic growth in recent years has derived from high tech output and investment at sharply falling prices. Essentially, the steep price decline in such a large part of GDP growth has played a key role in keeping the inflation rate down. That, however, is definitely the work of technology, not of monetary policy. In this light, the decline in U.S. inflation appears easily understandable without conjecturing an economic miracle.

FORGET ABOUT A FED RATE HIKE

Whether or not Mr. Greenspan really believes what he says about a possible "new paradigm" economy, he gives at any rate the impression of being rigorously opposed to any rate hike, however small. This comes as no surprise to us, as we have never expected any serious tightening from him. Some remarks in his Stanford address make clear that he is just as unconcerned about speculative excesses in the financial markets.

He does explicitly mention the example of Japan in the late 1980s, where "soaring asset prices distorted resource allocation and ultimately undermined the performance of the economy despite stable prices of final goods and services". But he ends up by saying, "We have chosen product prices as our primary focus on the grounds that stability in the average level of these prices is likely to be consistent with financial stability as well as maximum sustainable growth." Typically, he follows up with a remark that qualifies this statement again: "History, however, is somewhat ambiguous on the issue of whether central banks can safely ignore asset markets, except as they affect product prices."

"Between asset and product inflation, asset inflation is indisputably the most destructive of the two, requiring therefore the highest vigilance."

With these last words, Mr. Greenspan, actually, made plain that he accepts only rises in product prices as valid indicators of inflation. What's more, he even elevates them to a token of financial stability. No further hint, on the other hand, to "irrational exuberance" in the stock market. Rather, he virtually gave it his blessing with the words: "The equity market itself has been the subject of analysis as we attempt to assess the implications for financial and economic stability of the extraordinary rise in equity prices — a rise based apparently on continuing upward revisions in estimates of our corporations' already robust long-term earnings prospects." In short, the last thing to fear is a determined move by the Fed to squelch financial market speculation.

THE MOST HARMFUL EFFECT OF INFLATION

Contrary to Mr. Greenspan's view that stable producer prices tend to be consistent with financial stability, logic and history speak for just the opposite, and that is not by accident. It is precisely the low rates of product inflation that regularly mislead central bankers to overaccommodate asset price inflation.

Logic and history further firmly suggest that asset inflations by their very nature are specifically susceptible to overextend and imperil the financial system, which essentially is the financier of these excesses. As inflated asset prices later collapse, the whole financial machinery breaks apart under the weight of masses of surfacing bad loans. What precipitated and prolonged the U.S. depression of the 1930s was nothing but the complete disruption of the financial markets as the aftermath of the financial excesses in the 1920s. And, please, look to the present economic and financial quagmire in Japan. In brief, between asset and product inflation, asset inflation is indisputably the most destructive of the two, requiring therefore the highest vigilance.

What, other than rampant asset inflation fostering a massive misdirection of resources into property and industrial malinvestments, has shattered the economic "miracle" of the Far Eastern Tiger countries? Product

price inflation, ranging earlier this year before the tremors, was generally below 5 percent and as low as 1.6 percent in Singapore. Compared with growth rates in real GDP of 7-8 percent, these inflation rates appeared to everybody rather benign, thus nurturing the illusion of healthy, balanced economic growth. Yet the handwriting of runaway inflation was spectacularly on the wall in the exploding financial and credit flows, with the expansion of bank lending at rates between 20 percent and 40 percent.

"NEW ERA" BANKING

In August's letter we stated that globalization, innovation and deregulation have fostered unlimited money and credit creation for financial speculation, sanctioned by central bankers whose thinking begins and ends with consumer price inflation.

Nowhere has this development been as dramatic as in the U.S. banking system, with its new wave of mergers and acquisitions signaling the industry's aggressive move into security underwriting, money management and other non-traditional bank businesses both domestically and abroad. One only needs to look as far as the Wall Street Journal to discover page after page of "tombstones" advertising deals underwritten by the likes of Citicorp, Bank America, First Chicago and NationsBank to understand the prominence these banks now have in underwriting.

Indicating the feverishness of deal-making in the financial sphere, NationsBank after their recent $1.2 billion purchase of aggressive investment bank Montogomery Securities, is paying $15.5 billion — or an unprecedented four times book value — for Barnett Bank. This comes after First Union has paid two times book value for Signet Bank. By contrast, analysts of not so long ago used to become concerned with deals priced at two time book value. Eager to profit also from the hot securities market, banks have spent over $20 billion so far in 1997 acquiring investment banking firms and other former nonbank businesses.

From the Federal Deposit Insurance Corporation's (FDIC) recent profitability report it is not too difficult to see what is driving banks to such aggressive expansion in every field. Aggregate second quarter net income for the 9,308 insured banks grew only 1 percent from the previous quarter while growing 6 percent from a year ago. Credit-card write-offs rose to a record 5.22 percent, up 30 basis points from the last quarter and 74 basis points from last year. Indeed, profitability dropped 35 percent for the 74 banks at which credit cards account for more than half of total loans. To satisfy Wall Street's mandate of uninterrupted strong earnings growth, desperate measures are in order.

The net result of the banks' frantic pursuit of higher profits is twofold: 1) unfettered credit expansion, made possible by loan securitization, and 2) the move into other financial services of all kinds.

The first part of the profit-boosting strategy, rampant credit expansion, is realized through a rapidly growing share of fee-producing loan securitization. This, by the way, obliterates capital ratios as a regulatory restraint on credit growth, and thereby frees up capital for further lending, which largely goes into financing the merger and acquisition mania.

Over the last twelve months, the loans on the books of the banks have risen at a rather stiff rate of 8.5 percent, even though loans are taken off the books at a record rate by securitizing and selling them to the public. According to American Banker, asset-backed issuance will reach $25 billion for September alone, in a "surge in supply which is unprecedented in the asset-backed market's ten-year history and will test investors' appetite". Loan securitization is this year in for a record total of at least $180 billion, compared with an increase in the loans held on the banks' books of $230 billion, not to mention the continuing Wall Street boom with record IPOs, junk bonds, and corporate debt issuance. A convenient side-effect of this massive loan securitization is to keep money growth far below credit growth.

The second profit-enhancing strategy — to encroach on lucrative investment banking and financial services of all kinds — is evident in the fact that commercial banks are now leading underwriters of junk debt and major players in asset-backed securities. Along with many acquisitions, banks, almost across the board, have been aggressively building money management divisions. In a clear sign of the times, many large banks are selling mutual funds and investment annuities, and are rushing to offer customer accounts that bundle security brokerage with traditional banking services, so-called "Cap accounts". Last but not least, banks are aggressively expanding into the derivatives markets.

It seems to us that even among the policy makers, let alone the public, there is no longer any sense for the insanity that is ruling these markets. Barely noticed, Goldman Sachs reported for the third quarter a rise in pretax earnings of 58 percent, $932 million, as 1997 is easily on track to be the most profitable year in its 128-year history. A recent Wall Street Journal story chronicled Nicholas Rioditi, the "latest hotshot of Soros Fund Management". As an outside investment advisor, he is reported to run "leveraged trading positions totaling $57.6 billion, with equity of $2.4 billion". Please compare the position of this one player with the fact that annual U.S. personal savings amount to about $240 billion.

DEFLATION HUMBUG

In its just published World Economic Outlook, the International Monetary Fund notes that the world economy should achieve this year and next its strongest growth in a decade. But its estimates of 4.2 percent and 4.3 percent are slightly less than what it had predicted in May, when it was still highly optimistic about the outlook for Southeast Asia. Most of the increase is expected to come from the developing countries and the former communist countries. We have some difficulties to conjecture this group of countries as the locomotive of the world, in particular in face of the economic and financial troubles in the Far East.

Not surprisingly, there is an immediate inclination to belittle the woes of these countries. Their share in world trade may not appear very impressive, yet they have for years been the world's top growth area. Most importantly, their financial systems are gravely impaired through masses of bad loans and currency mismatches. Good advice from international bankers comes a bit late. Above all, their financial calamities are tremendously aggravated by currency calamities, due to being deficit countries heavily dependent on capital inflows.

Altogether, we see an increasingly fragile world economy that makes us optimistic of low persistent inflation. Only the U.S. economy seems to be in good shape. To many, it is in its best shape ever. In the last letters, particularly, we have outlined the major bubble traits in the U.S. economy, consisting of a host of serious imbalances, all resulting directly or indirectly from unfettered money and credit creation for financial speculation, with substantial spillover effects on the real economy.

Just compare the astronomical scale of the flow of funds into global financial markets with the meager supply of current savings, and you get a good sense of the insanity at work. Yet, referring to economic weakness in most of the world and the collapse of the Southeast Asian currencies, there is even some talk of global deflation caused by excessive monetary tightness. Let's be absolutely clear about one thing: all the economic and financial troubles, actual and latent, have their one and only root in past and present excessive monetary looseness.

The collapsing equity and currency markets in Southeast Asia are a cruel reminder of how apparently "healthy", liquid markets can quickly collapse in illiquidity; and also of how dependent economic activity today is on the well-being of the financial markets. Consider the Japanese "bubble" economy of the late 1980s being followed by over six years of trauma for their financial system, and yet no end in sight.

CONCLUSIONS:

Bulls say business as usual. We say maybe not. Wild speculation has returned to the relatively narrow market of small caps, but nervousness surrounds the big market leaders that dominate the indexes and derivative trading. Unless new leadership develops in the large caps, indexes are vulnerable to selling in the cash market and derivative-related selling from hedging programs.

Continued excellent inflation news and loud "New Era" musings by Mr. Greenspan have erased any rate hike fears far into the future and thus have guaranteed loose money as far as the eye can see. These developments have also breathed new life into the U.S. bond and stock markets. For many, these are reason to celebrate, yet nowhere is there the kind of impetus that has recurrent effects.

Such recurrent effects depend crucially on earnings prospects. We have explained why they are dismal. Yet never underestimate the cunning of Messrs. Greenspan and Rubin and of Wall Street and corporate management to stoke the furnaces of speculation. Immediately after issuing its earnings warnings, Gillette embarked on massive stock repurchases. But miserable productivity trends do not allow for a coincident acceleration of growth of output, profits and dividends.

There is a very high probability that the U.S. dollar has seen its high against the D-Mark and the European currencies. Its past strength owes a lot to the international carry trade and to heavy Treasury purchases by foreign central banks. The hype about the U.S. economy and the dollar is completely misplaced. There are four key fundamentals to a truly healthy, growing economy: 1) high savings ratios; 2) high investment ratios; 3) high productivity growth, and 4) a strong balance of payments. The U.S. economy possesses not a single one.

There is a general inclination to belittle the currency and financial turmoil in Southeast Asia with reference to their strong fundamentals — high savings and investment ratios. That's nonsense. Japan had even stronger fundamentals, including a huge trade surplus. And where is the Japanese economy six years after the bursting of the bubble? Just as in Japan, plummeting property prices and fast-rising bad loans threaten a banking meltdown. But in addition, banks and corporations are heavily exposed to dollar and yen debts.

One of the remarkable things about the currency and stock market crash in Southeast Asia is that it has come about in the absence of any monetary tightening or any dramatic event that pricked the bubble. The collapse only needed a growing realization that the excesses, particularly in Thailand, were unsustainable. Regional contagion did the rest. To be sure, it means still fiercer global competition.

Yes, it's right that Germany, France and other European economies are recovering, but don't think that this helps the rest of the world. On the contrary, the recovery is narrowly based on exports. ■

THE RICHEBÄCHER LETTER

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